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SUBJECT: HARPER GOVERNMENT'S FIRST BUDGET DELIVERS TAX CUTS, SECURITY SPENDING, AND BLOC QUEBECOIS SUPPORT

REF: (A) OTTAWA 513 (FINANCE MINISTER FLAHERTY)

(B) 05 OTTAWA 3399 (LIBERALS' FALL BUDGET)

SUMMARY

¶1. Tax cuts for households and businesses, breaks for families with children, and investments in defense and security were the key features of the Harper government's first budget, which was unveiled in Parliament on May 2 and is widely viewed as targeting middle class voters. Crucially for this minority government, the budget has support from an opposition party, the Bloc Quebecois, thanks to a companion document which recognizes the federal-provincial "fiscal imbalance" and sets out principles for addressing it in the longer term. Together, the Conservatives and the Bloc have enough votes in Parliament to carry the day, despite NDP and Liberal vows to oppose the budget. This budget was designed for popular appeal rather than economic principle, with a view to transforming the government's Parliamentary minority into a majority in the next election. Budget documents are available online at www.fin.gc.ca.

¶2. The government expects the budget to remain in modest surplus this year and next, but there is little room for error if the economy turns downward. Economists, while generally positive, judged that the budget will mildly boost an economy which is already running at full capacity. This means that tight restraint on other spending commitments will be needed in order to contain inflationary pressure and limit the need for interest rate hikes. Even so, the appreciating Canadian dollar seems set to continue its climb above 90 U.S. cents. This will deepen the rift between sectors which are prospering (energy, commodities) and those suffering (manufacturing, tourism) in the current mix of a climbing dollar, rising interest rates, high materials costs and a tight labor market. End summary.

TAX CUTS ALL ROUND

¶3. In his speech to Parliament outlining the budget, Finance Minister James Flaherty sustained his themes of "focus" and delivering on commitments, while announcing a range of tax cuts that appeals to many constituencies. Highlights are:

-- Reducing the value-added-type Goods and Services Tax

(GST) from 7 to 6 percent effective July 1.

-- Reducing the general corporate tax rate from 21 to 19 percent (this reduction was promised by the previous Liberal Party government a year ago but then withdrawn in order to obtain the New Democratic Party's support).

-- Eliminating the corporate surtax in 2007-08.

-- A tax credit of up to C$1000 on employment expenses.

-- Eliminating income tax on scholarships and bursaries.

-- Tax credits on textbook purchases, enrolment fees for children's sports and fitness programs, and monthly passes on public transit.

¶4. These tax cuts were partly offset by an increase in the lowest personal income tax rate from 15 to 15.5 percent (this half-reverses a cut from 16 percent made by the Liberals last year).

SPENDING PROMISES ADD UP TO BILLIONS

¶5. While it put the government's tax-cut and "frugality" messages foremost, Flaherty's budget speech also outlined a range of major spending promises, with little mention of the offsetting cuts which these imply. Following are highlights on the spending side. (While these figures are understood to represent new funding, such figures are often obscured by
Qto represent new funding, such figures are often obscured by
re-announcement and double-counting):

-- C$5.5 billion for infrastructure. This potentially covers a wide range of items, but it explicitly includes urban public transit, border facilities, and highway approaches to the border.

-- C$3.7 billion over two years for a child care allowance to families ($100/month for each child aged 6 or under).

-- C$1.1 billion in the current fiscal year (which began April 1) for defense, and a cumulative C$5.3 billion over five years. This does not include a specific commitment to fund the purchase of much-needed strategic or tactical airlift.

-- C$1.5 billion in additional funding this year for farm support.

-- C$1.1 billion for housing.

-- C$400 million over three years to fund "worker adjustment" in the softwood lumber industry and to manage the consequences of the pine beetle infestation.

-- C$307 million for immigration settlement.

-- C$303 million over two years for border crossing programs for low-risk travelers.

-- C$161 million for recruitment into the RCMP (the federal police service) and the ranks of federal prosecutors.

-- C$101 million to begin the process of arming border guards.

¶6. Observers commented that the government's statements and figures imply a need for offsetting cuts in spending which were not detailed in the budget. Cuts are expected in at

least three main areas:

-- Public sector labor agreements (this will require a tough GOC stand in future negotiations).

-- Programs for native communities (the budget provides much less funding than promised by the previous government under its so-called "Kelowna accords" with First Nations).

-- The environment (the Harper government has distanced itself from the Kyoto Accord and the budget cuts funding to related programs in order to fund the tax credit for transit passes).

REACTION/ANALYSIS

¶7. Reaction to the budget has been generally positive, though with some targeted criticism from the left, particularly of the child care allowance (which some see as an abandonment of public daycare programs) and from aboriginal groups disappointed with the lack of commitment to follow through with the Kelowna accords. Business reaction was enthusiastic.

¶8. Economists and financial analysts were similarly positive, though with notes of caution. Few were concerned about deficits, as GOC revenues have run well ahead of projections this year, and most seem confident that the Harper government will contain spending. Even so, the budget's package of tax cuts and spending will be mildly stimulative. This raises the likelihood that the central bank will need to offset its macroeconomic impact through monetary policy.

¶9. The Bank of Canada, in a monetary policy report released just last week, judges that the economy is already at or above full capacity and that, despite a string of interest rate hikes over the past year, more monetary tightening is likely to be required to guard against inflation (currently around 2 percent). That report, contrasting with more sanguine remarks from the U.S. Fed, has helped drive the already oil-fuelled Canadian dollar to highs not seen since the late 1970's.

¶10. The current mix of high energy costs, tight labor markets, rising interest rates and currency appreciation (not to mention global competition) has been especially painful for central Canada's manufacturing base, and for them, no relief is in sight.

WILKINS